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Corporate Bankruptcy Panel: A Debate Among the Players in a Modern Chapter 11 Drama: Who Needs Chapter 11 When You Have § 363?

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CORPORATE BANKRUPTCY PANEL
A DEBATE AMONG THE PLAYERS IN A MODERN
CHAPTER 11 DRAMA: WHO NEEDS CHAPTER 11 WHEN
YOU HAVE § 363?

Kay Kress^{*}

Gary Marsh^{**}

Alan Pope^{***}

Mark Duedall (Moderating)^{****}

Gwendolyn Godfrey (Moderating)^{*****}

MR. CLAMON: All right. We'll go ahead and get started if I could have everyone's attention. Welcome back. We hope you enjoyed the break and the snacks. This year we're pleased to have a wonderful corporate panel with us entitled, *A Debate Among the Players in a Modern Chapter 11 Drama: Who Needs Chapter 11 When You Have Section 363?*

I'd first like to introduce our debaters. We have Kay Kress. Kay is a partner in the corporate restructuring bankruptcy group of Pepper Hamilton, LLP. She concentrates her practice in corporate restructuring, insolvency, and bankruptcy matters. Kay is a Fellow in the American College of Bankruptcy, and is the incoming Chair of the Business Bankruptcy Committee of the Business Law Section of the ABA.

Next we have Gary Marsh. Gary is a partner with McKenna, Long & Aldridge, LLP. He is a graduate of Emory University School of Law, serves on the Advisory Board of the *Emory Bankruptcy Developments Journal*, and is an Adjunct Professor of Bankruptcy Law at Emory Law School. He is also a Fellow in the American College of Bankruptcy.

Next we have Alan Pope. Alan is a member of the law firm of Moore & Van Allen in Charlotte, North Carolina. He primarily counsels financial institutions in corporate workouts and bankruptcy, and in structuring inter-

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creditor arrangements. Alan is a graduate of Emory School of Law where he was a Robert W. Woodruff Scholar and the First Honor Graduate.

Moderating our panel today we have Mark Duedall. Mark is a partner with Bryan Cave, LLP. Mark works in the Bankruptcy, Restructuring & Creditor's Rights group. Mr. Duedall is a member of the Bench and Bar Committee for the U.S. Bankruptcy Court for the Northern District of Georgia and of the American Bar Association where he serves as the Chair of Bankruptcy and Workouts Subcommittee. Mr. Duedall is also a member of the American Bankruptcy Institute and serves on the *Emory Bankruptcy Developments Journal* Advisory Board.

Finally, we have Gwendolyn Godfrey. Wendy is an associate at Bryan Cave's Bankruptcy, Restructuring, and Creditors' Rights group. She concentrates her practice in the areas of bankruptcy litigation, commercial collection, and corporate restructuring. She is a Georgia Super Lawyers Rising Star and serves on the *Emory Bankruptcy Developments Journal* Advisory Board. So at this time I'll turn it over to Wendy.

MS. GODFREY: Thank you, Alex. For our panel today we've proposed a hypothetical to start us off. The following hypothetical features the issues and the push and pull, if you will, that we've seen of late in chapter 11 cases when you have a debtor and an estate that clearly would benefit from a going concern sale, but you have a secured creditor that, for better or worse, has the ability to put the debtor on a very tight leash in executing a sale.

So our hypothetical today: The company, we'll call it Debtor Co., owes \$20 million to its lender. We'll call it Bank. Sorry we couldn't come up with more exciting names for the constituents.

Bank has a perfected, first priority lien on all assets of Debtor Co.

Debtor Co. also owes \$5 million to various trade creditors, landlords, and the like. Of that \$5 million, \$2 million is on account of goods delivered to the debtor in the ordinary course of business in the 20 days prior to the petition date, or your § 503(b)(9) claims.

All parties agree that the liquidation value of Debtor Co. is \$6 - \$8 million. All parties also agree that the going concern value of Debtor Co. is \$10 - \$12 million and Debtor Co. has received offers from reputable buyers in that range.

All buyers have indicated that they will only go forward with a § 363 sale in bankruptcy; no interest in assuming leases, paying legacy creditors, taking on executory contracts, etc. Essentially, they want the protection of a free and clear sale order.

Debtor Co. is operating on a negative cash flow basis, believe it or not, but just barely. In other words, for every dollar in revenues, it incurs \$1.02 in costs due to high leases, inefficiency of operations, and general overhead. Of course, these losses are prior to professional fees, lenders' fees and interest, and all other restructuring costs which are disproportionately high, if you will.

After months of forbearance and failed attempts by Debtor Co. to raise new capital, Bank indicates it will promptly exercise its remedies unless Debtor Co. files bankruptcy and immediately pursues a § 363 sale.

Debtor Co.'s owners are done, with a capitol D-O-N-E. They have no interest in putting in any new money to save Debtor Co.

Bank, and it's important at least initially for our scenario here, that this is Bank making the proposal, will allow Debtor Co. 60 to 90 days to complete a § 363 sale. It will fund postpetition administrative expenses pursuant to a budget including \$75,000 per month for professional fees, but only if Debtor Co. agrees to accept Bank's very generous offer of postpetition financing from Bank in the exact amount necessary to pay off the prepetition loan balance. And I will hand it over to Mark.

MR. DUEBALL: Thank you, Wendy. Good morning. We have tried to devise this hypothetical based on actual events. I believe most bankruptcy practitioners would tell you that this represents the vast majority of chapter 11's now and in the past several years, of any size whatsoever. This is very true to life. This is a very challenging situation. Our panelists are going to defend their respective views on it, but we tried to devise something that would be helpful to the practitioners and to the students. There's a couple of things we want to emphasize here before we get into our questions.

You'll note there's \$5 million in trade credit. In the good old days, that would be fine. That could be your impaired accepting class, and you need an impaired accepting class to get out of bankruptcy, to confirm a chapter 11 plan. The difficulty now is, \$2 million of that \$5 million was incurred during the 20 days before bankruptcy on account of goods delivered in the ordinary course of business. Under § 503(b)(9) of the Code, that's an administrative claim. You cannot impair that claim without its consent, and it's owed to a wide variety of

trade creditors. So now you have a \$2 million block to getting out of bankruptcy. You must pay those administrative creditors in full. They do not vote. They do not need to vote because they're entitled to be paid in cash. So we have that impediment.

The company is barely cash flow negative before the bankruptcy. But perhaps it could become cash flow positive. We don't know. In bankruptcy, you can reject leases, you can restructure your operations, you can shrink your employee base. You can possibly come up with better terms with your vendors or your customers. And so it's important that you understand that this is a company that is losing money every single day, and it's coming out of the hide of the secured lender because that's the only one whose hide it can come out of.

But perhaps it could turn around. There is a DIP loan that is offered. It is offered with tremendous strings attached. The DIP loan is to take the prepetition balance and convert it into a postpetition balance, so no money will actually change hands here. But a prepetition claim that is secured will become a postpetition claim. And why is that important? It gives the lender a blocking position on any chapter 11 plan. It is now a postpetition claim, just like the § 503(b)(9)'s are administrative claims. And postpetition claims, as you know, must be paid in cash in full to get out of bankruptcy. So cramdown is no longer in the vernacular for a secured lender when it rolls its prepetition claim into a postpetition claim.

The secured lender has indicated it would be willing to offer this loan, if you will, if the debtor would do an expedited sale process, and preserve the going concern value of \$10 to \$12 million. The market has spoken, the bids are in, and people are willing to bid \$10 to \$12 million. A proper sale process has been run, but the lender is not willing to wait around. They only want this case to go on for 60 to 90 days because the company is losing money. And every dollar the company loses must come from somewhere, and generally that's going to be the lender. So the lender said it can only allow this case to go on for 60 to 90 days.

It has offered tribute, if you will, in the form of allowing certain professional fees if the parties dance to its tune, and that's a common attribute as well. Someone must pay for the case. The lender has to pay for the case, but the lender certainly wants something for that.

Now, Alan, you would agree. We'll start with Alan representing our secured lender. He does that in his career as well, so this is not unusual. You would agree this is a somewhat realistic hypothetical, perhaps not the motivations, but the hypothetical from the bank's perspective, correct?

MR. POPE: I would agree that it is a realistic set of facts. Probably the only nuance is usually the DIP would not be in the exact amount. I'm going to have to put a little bit of new money into the game, not only because the company needs it but because that little bit of additional cash is that carrot that makes me look even more reasonable to the court than I already am.

MR. DUEDALL: And we know you love to look reasonable. But in fact, you would admit, would you not, that the bank here is the lender in possession? The bank is dictating everything that will happen in this case. The bank is dictating how long this case will take place. The bank is dictating costs that would be paid pursuant to a budget. And you are here today, is it not true, in front of your cherished alma mater, to repent and agree that you shall never again represent a lender in possession? Please absolve yourself, Alan.

MR. POPE: I have three children that need to go to college, so I will continue to represent those lenders. The only thing we're in possession of is a loan that we probably in hindsight would not have made. I'm in possession of a first priority perfected security interest, and that was my deal when I went into this.

MS. KRESS: Maybe. Maybe.

MR. POPE: And that is the perspective—

MS. KRESS: Maybe you have a first priority.

MR. POPE: Well, if there's avoidance issues, we have to address those, but my deal when I went in with respect to my pricing was I wanted a lien. I'm going to loan money, I'm going to charge a particular rate of interest, and that rate of interest is probably a lot less than I should have charged. And I have a set of expectations that come with that. Now, the fact that this company has deteriorated and is not performing any longer doesn't really change the nature of the bargain I have, and that is that at least to the extent my lien is attached to that collateral, I'm entitled, maybe not specifically to the collateral, but at least to the value that it represents. So do I think I'm being unreasonable when I go into a case and say, I want to maximize that value, I want to see it sold, I want to preserve the enterprise as a whole and sell it to this buyer who's willing to

pay more than anyone else at the table? I think I'm acting eminently reasonable.

MR. DUEDALL: Even if you dictate all of these terms, contrary to the way Congress thought, there's no give and take here. This is the lender's case; this is Alan's case. That does not bother you at all?

MR. POPE: I don't think you're dictating it. What you're saying is that I have a certain set of rights that come with my security interest, and because of that, in order for you to use cash collateral, in order for you to exist and make it a functional bankruptcy case, you have to come through me and get my consent to do certain things, and I'm clearly going to put conditions upon that.

MR. DUEDALL: Goodness, Judge Pope. You must come through him. Now, Kay, on the opposite side, you represent creditor's committees; is that not correct?

MS. KRESS: Correct.

MR. DUEDALL: Now, in this case, creditors are hopelessly out of the money. The company is worth \$10 to \$12 million, perhaps \$12.5 million, perhaps \$13 million, but the lender is owed \$20 million, so the creditors are completely out of the money. And you would agree then, would you not, that you, too, shall repent and in cases such as this you would disband this committee. You'd play no role whatsoever; is this true?

MS. KRESS: Absolutely not.

MR. DUEDALL: What role could you play? You're out of the money hopelessly.

MS. KRESS: If the lender would like to participate and use the Code to sell the assets for its benefit, then it needs to leave something on the table for unsecured creditors to do that. And we can do that in a variety of ways. We can try to button down the budget. I would also like to ask Alan how much fees he's going to get out of his DIP loan. What kind of releases does he think he's going to get out of his DIP loan? And we're going to look at his loan documents to make sure that he's properly perfected because they may have made some mistakes there, so the assets may not be totally encumbered.

MR. POPE: And so even though she's wearing this wonderful business suit, what's really happening is she's pulling out a pistol. She has a little mask and she's essentially saying we need some grease for the skids, and that's exactly

what's going on in chapter 11. Now I would have to concede that secured lenders know this, and we know that it's a pay-to-play system. My issue with it is if you go into the Bankruptcy Code and look at all those provisions, nowhere in there does it say that secured creditors are a lower class of creditors, that we're not entitled to use bankruptcy courts to vindicate our state law priorities in this collateral.

MS. KRESS: In a chapter 7 case, I think undoubtedly in any jurisdiction, the court is not going to allow a trustee to liquidate collateral for a secured lender without something for the unsecureds. So why should chapter 11 be any different?

MR. POPE: When you get to that straight liquidation, the point there is that we in fact will usually get relief from the stay or have the assets abandoned, and then we can undertake a liquidation type sale. We're not going to see a going concern sale. I think the real difference in a chapter 11 is the going concern. And ultimately it's because I've talked to this gentleman next to me, and we've probably been working together now for 18 months and probably gone through six different forbearances. He's probably had a little bit of equity come in and it ended up being a bad decision. What we're making is a process and a procedure to preserve the enterprise value, to preserve a going concern.

MS. KRESS: For your benefit only.

MR. POPE: I would say for the benefit of the company itself, but certainly for our benefit, too, yes.

MS. KRESS: So maybe we convert the case because it's only for your benefit, so what's the downside to converting the case?

MR. POPE: Maybe I'm missing that Code provision that says if only one creditor gets a benefit, we should liquidate. What Kay's saying, though, I think is an attitude that you will see. There's no question that there are certain expectations of secured creditors when we go into bankruptcy cases that, for example, if I'm going to try to grab a lien on avoidance actions, I'm going to get my hand slapped very quickly. And the idea is that, no, that's the one source of recovery for unsecureds that they tend to hold sacred. Where does it say that in the Code? Nowhere.

MS. KRESS: But you don't have a lien on the avoidance action. Going in, you do not have a lien, so you're going to be asking to get additional collateral on a postpetition basis.

MR. POPE: No, but I will be asking as part of my adequate protection package for replacement liens, and I would like it to extend to that. Certainly with respect to a DIP, I would want it to extend to avoidance actions. And in particular we also are very careful about what avoidance actions, if we ever do carve something out, to make sure we exclude from that carve-out § 549 actions, which is of course my own DIP proceeds going in and going out the door inappropriately.

MR. DUEDALL: Well, now I have a question for Gary. Before we get to that, this dialogue is helpful and is beneficial to the group, but no one ever mentioned the words chapter 11 plan in here at all. Is that okay? You two have just decided it's a foregone conclusion that this shall be a § 363 and that's the way this case will go? And we should all just deal with that? Kay and Alan, is that right?

MS. KRESS: Well, I will tell you I had a case once where a judge would allow a § 363 sale but would not allow distribution without a plan or a motion to all creditors that substituted for a plan in a chapter 11. Because in his opinion the only way to exit a chapter 11 was through a plan or to convert the case to a chapter 7 for distribution purposes.

MR. DUEDALL: Alan, would that be acceptable to you, a § 363 sale followed by months or years of negotiation over a plan and professional fees and what not?

MR. POPE: No, because I'm going to want those proceeds paid to me at the time of the § 363 sale. That's going to be very, very important to me. If it in fact converts to a chapter 7 after that sale takes place, I'm probably okay with that. What I don't want to do is have a DIP which I put in place that's going to sit there and fund losses for the next year to 18 months. In modern chapter 11 practice what really motivates secured lenders to use § 363 is that they're paying me, they're paying a financial advisor, they're paying the debtor, they're paying the debtor's financial advisors, they're paying Kay, they're paying Kay's financial advisors. And the burn rate in a modern chapter 11 is extremely, extremely high.

MR. DUEDALL: None of this is problematic by the way. We're pleased to hear this.

MS. KRESS: Alan, but what statutory authority is there in chapter 11 to sell substantially all the assets and distribute proceeds without a plan? Where is there any statutory authority for that?

MR. POPE: I would say under § 363(f)(3), if you're going to sell my assets and you want my consent to sell those assets, I want my money for that.

MR. DUEDALL: Well, Gary, you're in the middle between these two warring factions. You represent debtors often; is that right?

MR. MARSH: Yes.

MR. DUEDALL: There's little hope here to navigate toward a chapter 11 reorganization plan. We've heard a little discussion of chapter 11 liquidation plans or liquidating in a chapter 7. You're stuck in the middle here. If this is true and the end of the novel is known before you even open the first page, do you simply agree to Alan's terms, guide the debtor through a rushed process, and pocket the professional fees? Do you need to do anything else than that?

MR. MARSH: First, I want to thank you for getting me in the middle of these two. I'm beginning to sense that as the day continues I should have worn my football helmet because in my experience, this discussion can get a lot nastier soon, with elbows being thrown.

As debtor's counsel, we represent the company, so if the company is insolvent, and the old equity is done and won't put any new money in, then I think as company counsel my job is to maximize value, preserve jobs, preserve the enterprise and generate money for creditors. And the money should go to the creditors in accordance with state law and bankruptcy priorities. I think debtor's counsel has a role to play. There's nothing wrong with that, and if you can do that well and do it efficiently, you should be paid handsomely for it.

MR. DUEDALL: So the priorities tie your hands and you should just allow the process to take its course? That's debtor's counsel's role is to honor state law, let the proceeds go where they must go?

MR. MARSH: Yes. I mean, we'd meet with the board of the company if we can't come up with a plan of reorganization that we think is feasible and confirmable under the Bankruptcy Code. If we don't file for bankruptcy and just shut the thing down, that is going to harm the secured creditor. Probably going to harm parties with executory contracts too because in most of these cases some amount of payables get paid; some amount of contracts get assumed, jobs get preserved, and if you just let it shut down outside of bankruptcy that doesn't really help anybody. And if you file bankruptcy and convert it to a chapter 7 and liquidate it, that's not good for everybody involved typically.

MR. DUEDALL: Kay, what do you think of Gary's answer? Can he just stand by and in the interest of the community, the employees, the landlords, executory contract parties, the enterprise, can he just take the dive, if you will, and agree to Alan's terms, whatever they may be as long as they pass the smell test? And can he leave all the fighting to you? Do you prefer that? Can he do that?

MS. KRESS: I think as a practical matter he doesn't have a whole lot of leverage with the Bank. The debtor has signed loan documents. The debtor is bound by those loan documents. I don't know that they have a right to try to change the loan documents. But the debtor does have a fiduciary duty to the estate and to the creditors. So I don't think he can take a total dive. I think he's got to at least try to negotiate some reasonable terms. And as a practical matter, I do think the committee is the one who steps in and will have to fight because they don't have the relationship. They aren't bound by the loan documents.

MR. DUEDALL: The reasonable terms that Gary should negotiate, does that extend beyond a longer sale process and money for professionals? Does he have any obligation to ask for a carve-out for creditors? Or is that entirely not his role?

MS. KRESS: I don't know that he has an obligation to negotiate a carve-out for creditors. I would argue that he has an obligation to button down the costs of the company. We've already said we have overpriced leases. We have a lot of money going out the door to insiders, and the company would have the obligation to try to button down the expenses so that the loss isn't as great, or maybe there isn't any loss. And I would expect Alan to do the same on behalf of the Bank.

MR. POPE: The interesting part about modern chapter 11 practice is why I went into this area of law, and that is Kay and I will be throwing elbows, and then we'll also be talking on the phone. We're agreeing that, look at this list of executory contracts, why aren't these be rejected on day two of the case? Because both of us, if you go to this fact scenario, realize this § 363 sale is probably inevitable to some degree. If they're not going to take certain assets, you want to stop that aspect of the burn as quickly as possible. So one moment I'm getting requests for production of documents that I know is going to cost me \$500,000 to respond to, as I get every email within the Bank for the last seven years, and at the same time we're going through the list that's come over from Gary's office trying to figure out how can we tighten this down more. And so it's constantly multilateral. So while it can get vicious, the enemy today

is your friend tomorrow and you always have to keep that in mind. I think that's what actually makes chapter 11 practice very interesting for all of us.

MR. DUEDALL: You were saying earlier she points a gun at you but now she's your best friend.

MR. POPE: At least for that hearing, yes.

MS. KRESS: We have a common goal. We have a common goal to get rid of the excess overhead.

MR. DUEDALL: Now, Alan, let's talk about particular kinds of creditors here. You're familiar with administrative claims. Section 503 of the Bankruptcy Code sets forth administrative claims. Section 503 of the Code, unlike § 507 of the Code, does not allow for any layering. That is to say, § 507 of the Code deals with prepetition claims, priority claims, and it ranks them. There is a first priority. There is a second. There is a third. Congress has determined that they are in relative priority among each other. Section 503 has no layering. All administrative claims are created equal. They are all identical under the Code.

Now, in this case, there's \$2 million of prepetition administrative claims, a creature that did not exist before 2004, prepetition administrative claims. You would agree, would you not, that any budget you will approve, any postpetition budget, will not contain anything for these § 503(b)(9) claims, these prepetition administrative claims? What basis do you have to refuse to fund certain administrative claims and to fund other administrative claims? Congress has made no such distinction.

MR. POPE: It's an interesting issue that's posed by § 503(b)(9). You have prepetition creditors who, at least in the eye of other unsecured creditors that Kay is dealing with, probably don't like the fact that they've been raised in status. I personally don't want to fund a DIP that's going to pay this prepetition creditor who, by definition, I really don't need for my § 363 sale. So why am I ever going to advance funds under a DIP or approve in a budget payments to these creditors I really don't need? The only reason I would ever need them, and need this satisfied, is if I'm forced to do this chapter 11 plan that everybody is talking about and I have to get that administrative claimant paid.

Now, what's the one exception to that? When do I actually offer up money and say, I'm okay with this going to a § 503(b)(9)? Well, it's essentially when it's a back-door critical vendor motion, and that there's something about those

particular people that I need to make this sale happen. That's when you'll see me step up and offer to pay them money.

MR. DUEDALL: But what provision of the Code says administrative claims are actual necessary costs of the estate or ones the Bank needs, to use your words, in its discretion? How can we deviate from the Code in that fashion?

MR. POPE: I look at it this way: in the situations where I'm willing to pay, I ultimately will leave it to the § 503(b)(9) creditor and to Kay as to whether the court will permit it to be paid at that time. If I'm requiring it to be paid, there's other ways and other avenues that I have, potentially under the § 363 sale having those claims paid by my purchaser, or there's other things that I can do. But for the most part, with respect to timing of that payment, we'll defer to the court, and nine times out of ten I'm going to wish that they weren't paid at all because it's coming off my DIP in any circumstance.

MR. DUEDALL: Now, Kay, suppose Alan sweetens the bank's offer. You'll recall the offer at the start of the case was we will run this case for 60 to 90 days, and do a proper final sale process. We will fund a budget for administrative claims except for the ones he does not need. We will fund a certain amount of professional fees, and Alan says he will also carve out of the bank's collateral, upon a sale, \$500,000 for the § 503(b)(9) claims. They are administrative claims after all. Not enough to pay them in full, but \$500,000 is a fair amount of money. Can you take that offer? Can you sell down the river the rest of the unsecured creditors and take Alan's money for these higher priority creditors? Can you do that?

MS. KRESS: As counsel, my position would be I do not represent those creditors. My committee is of unsecured creditors. To the extent that they're § 503(b)(9), they're administrative creditors. If they happen to have both and they're sitting on my committee, I would remind them of their fiduciary duty to all creditors. So I would not recommend to the committee that that's something that we could even entertain. We don't have the ability to bind administrative creditors.

MR. DUEDALL: Do you instead say that that \$500,000 should—

MS. KRESS: The unsecureds.

MR. DUEDALL: Should go to unsecureds?

MS. KRESS: Absolutely.

MR. DUEDALL: And in reminding your committee members of their fiduciary duties, I mean come on, there's creditors on there with § 503(b)(9) claims. You remind them. They nod their head, and then they tell you we are voting in favor of Alan's offer. What do you do?

MS. KRESS: Well, first we'll have to look at our bylaws that we've drafted to see if maybe they have to recuse themselves in that vote because they have a vested interest. The committee members themselves have a fiduciary duty to all creditors, and they are not to take that and do what's in their own best interest. So we may have to recuse them from that vote.

MR. DUEDALL: Do you eject them from the committee?

MS. KRESS: You just recuse them from the vote.

MR. DUEDALL: And so the § 503(b)(9) creditors that happen to be on the committee are recused. The rest of the unsecured creditors that are on your committee, the ones that are not lucky enough to have a § 503(b)(9) claim, they vote to accept that \$500,000 for their benefit and you have now sidestepped the priority scheme of the Code because now \$500,000 are going to unsecured, non-priority creditors ahead of administrative creditors. What Code provision allows you to sidestep the Code in that fashion?

MS. KRESS: Well, I would argue that Alan is carving out of his proceeds to pay the unsecured creditors. It's not property of the estate so I don't need any basis from the Code. He's gifting.

MR. DUEDALL: He's gifting?

MS. KRESS: He's gifting.

MR. MARSH: They're quite good friends. Now he's making gifts to her.

MR. DUEDALL: Well, my goodness. That is quite a gift. Would you consider this? That \$500,000, instead of going to the unsecured creditors as a gift, would you consider instead telling the bank and the court that the \$500,000 should go to an investigation managed by you and your firm of claims against insiders, Gary's clients? Gary's clients are the debtor-in-possession, but the officers and directors. Would you consider having the \$500,000, instead of going to creditors' pockets, whether § 503(b)(9) or regular, going toward an investigation instead?

MS. KRESS: Well, I think that depends on if there are valid claims. I would like to know is there a D&O policy. I would like to know, if there is no D&O policy and I'm only going against the insiders, what is their financial condition? Because I certainly am not going to spend a lot of money to only put it into the pocket of my firm, that's going to render no benefit to the unsecured creditors. So you have to look at a lot of different facts to see. I'm sure some of that would go to fraudulent transfer investigations, preferential transfer investigations, and if it appears that that's going to bring more into the estate than it will cost, then of course we're going to use some of that for that purpose.

MR. POPE: I think the other thing, too, is this is one of those situations where Kay and I together are going to be on the phone with Gary saying, have you looked at this \$2 million? Is it really \$2 million? When did they receive this? Was it really 20 days? Was it a good? Was it a service? Was it some hybrid of the two? And really try to whittle that number down. I think you'll see the § 503(b)(9) claims at least initially are far larger than they end up being in practice once they get through the claims reconciliation process.

MR. DUEDALL: Assume there are valid claims against insiders. They committed some wrongdoing. Not just moving right when you moved left—or you should've moved left—because that's protected by the business judgment rule. But they really did a few bad things in this six months or year leading up to the bankruptcy. And so, Kay, you've decided this \$500,000 should go to a proper investigation or at least should start to go toward a proper investigation. So, Gary, you have the committee frothing at the mouth to go after the directors and officers, yet there is no D&O insurance. Unfortunately, there was no money to buy a D&O insurance policy or a D&O tail. Do you ask on behalf of the debtor-in-possession that the postpetition budget include money to buy a D&O policy for the benefit of the D's and O's? If the Bank says fine, we'll let that money go out to buy that D&O policy, but we're going to shrink the period of time for the sale because dollars that have to go to pay for insurance are now dollars that cannot fund losses that are happening every single day. Are you a good fiduciary if you make that deal with Alan? Do you consider that deal with Alan?

MR. MARSH: Well, usually we deal with the D&O insurance prepetition. Usually there's a policy. In the year of negotiations and forbearance agreements we did with Alan we would have, in contemplation of bankruptcy, probably purchased a tail. So we have D&O coverage not only for the D's and

O's but for the company, and because we don't know where it's going to end up, there's value for the company to have directors and officers, and they typically require insurance, and we need to keep them on board. For the sale, if somehow we were funding that postpetition, if we needed some money, I'd push back hard with Alan. Already the sale process is expedited. We're going to have trouble with Kay on that. We're going to have trouble with the court. So it's not as if debtor's counsel isn't going to fight and negotiate with the secured creditor and try to reason with them about what's appropriate under the circumstances, and we probably would try to not shorten the process.

MR. POPE: I would fully expect Gary to call me up and say, I don't want to go in front of Judge, insert name, and change a process that was in the bid procedures order we did 35 days ago

just so that I can have this. So what am I going to do? I'm going to probably be asking for something else at the time, and I'm going to probably say that's fine. You're sitting on your hands lollygagging about getting rid of that corporate headquarters that you're in. Can't you move down to the Regis office space down the street and save us \$500,000? And that might be a little bit more of the conversation that we would have. I would find it very difficult I think to change the sale process unless for some reason this is so early on in the case that the bid procedures aren't even out yet.

MR. DUEDALL: Is this not a perversion? The only time we've mentioned the judge in this entire thing was when Alan said we don't want to tell the judge that. Is this not a perversion, these side deals taking place? Money going to unsecured creditors. Sidestepping § 503(b)(9). Money going to buy a D&O policy because the committee may investigate the D's and O's, and they don't want to have to pay for it out of their own pocket. Is this a perversion of the entire process?

MR. POPE: I think it's exactly what you want law to do. You want a predictable set of rules and results because if I know what the judge is going to do, I'm going to be able to cut the correct deal with Gary up front. If I know exactly what the judge is going to make me give Kay, it creates efficiencies in the process. If we're running back to court every week to decide these things, then I think that's when we have greater issues in a case, and that's when the administrative expenses go up and the chances of a chapter 7 increase dramatically.

MS. KRESS: I think chapter 11 contemplates these kind of negotiations. This is the process. This is what you do in chapter 11.

MR. DUEDALL: Even in a §363 sale?

MS. KRESS: Absolutely.

MR. MARSH: That's part of the Code, Mark. It's in there.

MR. DUEDALL: Well, my goodness. But in a chapter 11, though, there's things like § 1125 that require a disclosure statement, information is given to creditors that allows creditors to vote and be fully informed, as opposed to these back room dealings over cigars and Scotch, the sort of things I'm hearing of.

MS. KRESS: There is an argument that the sale is actually a sub rosa plan, and there has to be exigent circumstances to allow the sale to occur outside of a plan. There is always that argument that the committee can make. If it really is exigent circumstances and you're going to lose the value of the company to go through the process, then you haven't really benefitted anyone, the debtor, the bank or the creditors.

MR. POPE: I would suspect that the three of us are looking at this company, and we don't talk about this in the hypothetical but it's really, what is the difference between that liquidation value and that going concern? Is it because this is a cash flow business where we're talking about reputation, we're talking about speed and getting them out of the bankruptcy? You want to keep the headline exposure to a minimum. That's a very strong case that § 363 is the right way to go. If this was asset-intensive and I'm really an ABL lender sitting up here, then all of a sudden I think I have a much more difficult process in some ways in dealing with Kay because it's much easier for her to look at the judge and say there's nothing exigent going on here. They're fine, they're covered, their own advance rates cover them. They're not going to lose money, or it's not going to get any worse than it was on the day we filed the case. And that's when it becomes far more difficult for me.

MR. DUEDALL: Well, none of this is troubling to our panelists but I trust our audience will be asking questions later because this is very bothersome. Now, Gary, this is not unusual. The bank will recover more in an orderly § 363 sale than it will in a chapter 7 liquidation. There's a pittance being offered by the bank to insure that the creditors committee does not unnecessarily oppose things. The creditors committee may go after the insiders. The committee and

the debtor are now at war with each other through the bank's machinations. Should the bank have to also pay for the privilege of this liquidation, the privilege of this going concern sale that will recover more than a liquidation? Should there be a § 363 tax? Should there be a § 363 surcharge? The hypothetical contemplates more money will be had in a § 363, and a pittance going to unsecured creditors through these side deals, than in a chapter 7. Should there be a cost to that and should that cost be borne by the Bank in a surcharge or a formal tax?

MR. MARSH: I personally think the answer to that is yes. We're going to be negotiating hard with Alan to say, look, you've got to pay to play. You've got to pay all the admin. expenses of the case, and you've got to fund the bankruptcy to get us through a liquidating plan and leave something for unsecured creditors. And that's what we're going to argue hard with him on the front end and when we say pay the admin., we're going to tell him he should pay the § 503(b)(9) claims. He's got to pay the professional fees, and he's got to pay all the losses that are accruing in the business. He's got to fund that if he wants to realize the going concern value, and get the releases he wants and get the upside in the business. We're in a case right now in Delaware where the original deal on the table was none of that was going to happen. The committee objected forcefully about that. Judge Gross, who's the chief judge in Delaware, he was sympathetic to the committee's positions and we ended up cutting a deal where the secured creditor paid all the admin., the § 503(b)(9). They paid all the priority taxes. They paid the admin. through the closing date of the § 363 sale but not through the effective date of the liquidating plan. They left a \$2½ million cash tip for the unsecured creditors. The unsecured debt was about 16 million, and they assumed some payables and assumed some contracts, and they left the D&O claims. They took the avoidance action claims but they agreed to basically bury those so that if they wanted to bring them, and whoever they brought them against, would release the buyer of any claims, then they would drop the avoidance actions. That was the deal that was struck and approved, and I think that was appropriate. The lender ended up with the business and the company, and it was kind of a fair treatment to the other constituents.

MR. POPE: So I think he said there already is a surcharge.

MR. DUEDALL: So there is no need for a—

MR. POPE: It's not in the Code but there already is a surcharge.

MR. DUEDALL: But, Alan, wouldn't you agree § 506(c) does contain a surcharge? It covers most of the costs that Gary was talking about, the administrative claims and whatnot. Shouldn't Congress stand up for unsecured creditors and charge you for the value that you are having formally?

MR. MARSH: He makes me waive that § 506(c) surcharge in its documents. I waive all my rights.

MR. DUEDALL: Not as many debtors' lawyers are in the same position as Gary and Kay, nor are quite as skilled as them, and are not able to negotiate for such favorable treatment as Gary just described. Why not just even the playing field? An active provision, call it the § 363 surcharge. You're a quantitative guy, 10%. It's very simple. What's wrong with that?

MR. POPE: What's wrong with it is that I made this loan three years earlier, and keep in mind I'm a \$20 million lender. Chances are I've been paying these unsecureds for two years. Chances are I'm going to lose a lot of money on this deal no matter what. I bargained for a priority interest in collateral, and now what you're telling me is that I have a duty as an altruistic bank to carve up some portion of that collateral just to be a do-gooder, which if you knew Mark in law school this shouldn't shock you. But that being said, I recognize that implicitly we have built a system that requires a surcharge now, and that I know that when I go in to particularly Delaware or some other jurisdictions, I'm going to have to give something to the committee. I'm going to have to give something to Gary for administrative expenses and those types of things. The calculus I'm doing is, is that going concern sale of enough value to me, or would I rather take care of this in another way? One of the aspects of this, and we were discussing this at dinner last night, and I think if you go back and look at the title of our presentation, *Who Needs Chapter 11 When You Have 363*? You could go one step further and say, who needs bankruptcy? And we increasingly will try to do all of this outside of bankruptcy. Why? Because of these concerns.

MR. DUEDALL: These concerns about things like transparency, openness, disclosure, those sorts of concerns?

MR. POPE: Absolutely.

MR. DUEDALL: This is very disappointing.

MR. POPE: Now but keep in mind those out-of-court transactions, how do they differ? Well, first of all, those out-of-court transactions often result in the

unsecureds being paid in full. We're making a decision that to preserve enterprise value, I'm better off just taking care of the trade. Gary is actually doing his job. We're doing a debt-for-equity exchange. We're conducting a sale. We're trying to get a buyer happy with purchasing this outside of bankruptcy. And that is because of these costs and this surcharge, and it's a reasonable economic argument for me to make. Now the nuance on these hypotheticals we haven't really talked about is when you throw another set of creditors in here. When you have that second lienholder or a mezzanine financier who also has a lien, or you have an IP claimant who's claiming that Gary's client has been violating his patent for the last ten years and all they want to do is blow the company up because they're angry. That's when oftentimes we have to go into bankruptcy for no other reason than we have to have the stay, or ultimately have to have a plan processed to get over sort of consent issues.

MR. DUEDALL: So there's no need for a chapter 11 plan. There's no need for a surcharge or a tax. It's the normal jostling, and back and forth completely hidden from creditors or the court. Gary does not believe there needs to be a tax. There's sufficient back and forth and he's able to negotiate for things. Alan doesn't think there needs to be a tax. He knows he'll have to pay a little bit anyway but he doesn't want it explicit. Kay, do we need a tax?

MS. KRESS: Just for the reasons that Alan articulated, he's in bankruptcy for a reason, and the reason is he can't do this out of court or it's going to cost him more to do it out of court than in the bankruptcy court; therefore, he needs to pay for the ability to use the § 363 process. Maybe his buyer doesn't want to buy in a debt-for-equity swap because there are going to be successor liability issues. So he definitely wants to avail himself of the bankruptcy. In addition, I might ask, Alan, what kind of due diligence did your client do when he made the loan, the \$20 million loan for which the company could not sustain the debt service?

MR. POPE: Apparently not enough.

MS. KRESS: So you're not the innocent here. The trade creditors are the innocent. They're the ones that have been trying to keep the company going.

MR. POPE: Keep in mind the amount of money we lost was only twice the amount of the entire unsecured claims pool. That's why you talk about a tax coming into bankruptcy. A secured creditor for the most part is just a creditor.

They happen to have a lien. They're not a lesser species that is supposed to change its claims to make everybody else happy.

MS. KRESS: They also have other remedies that are stronger outside of bankruptcy. You can foreclose on the collateral. You can do other things than just general unsecured creditors, you can sue and get a judgment and, depending on the state, you may or may not have lien status, and it's always subject to the lien of the bank if there is a bank there. You have the ability to go in and foreclose. For some reason, the bankruptcy is a more attractive remedy for you. So therefore you should have to pay to use that remedy.

MR. POPE: I haven't seen that provision in the Code yet.

MR. DUEDALL: But that's the question. Kay, should it be a specific provision of the Code, a specific percentage that just comes off the top of a sale in a § 363 and goes to unsecured creditors? Or is the normal jostling simply enough?

MS. KRESS: I think as a practical matter, the normal jostling gives you that result. To actually put it into the Code, I'm not sure Congress ever contemplated that § 363 would be used in the manner in which it is being used.

MR. DUEDALL: It undoubtedly did not. It undoubtedly did not.

MS. KRESS: This is definitely a new phenomenon, and maybe they will use it in that way. So the normal jostling gets you to that point in most cases and sophisticated banks and bank lenders' counsel are going to understand this is the game that they have to play. And if they don't want to play, then they're going to have a hard time in chapter 11. Because I believe judges understand the game as well.

MR. POPE: I don't agree with it as a policy. I will say that to the extent it was clear and it was clear such that if that tax is paid, then all this other surcharge that's already in place implicitly, the greasing of the skids where I'm carving out money, and I'm paying for everybody else's professionals in the case, if I could take my surcharge and have the rest of that stuff go away, it might not be a bad deal and it would add a bright line element to chapter 11 such that you knew exactly what was going to happen and you could do the math and make your decision. Am I better off in? Am I better off out?

MS. KRESS: And there is a nuance. This whole scenario assumes that Gary and Alan have been working together for a long time. Now if Gary and Alan

haven't been working together and Alan is moving to enforce his out of bankruptcy remedies, and in order to stop that in the automatic stay Gary decides to file the chapter 11 and then he and I are on the same side, I'm not sure why the bank would be required to pay the surcharge. So if you just have statutory language that requires a surcharge in every scenario, you're then putting lenders, and now I'm arguing for Alan, but it's a different game than if the lender really wants the debtor to be in bankruptcy for the sale.

MR. DUEDALL: Well, let's move a little bit past this hypothetical. Frankly, I don't think our audience can take any more discussion of greasing the skids and pay to play and the game and whatnot. They're losing patience.

Assume all of the facts that we just laid out, but there is now \$1 million of unencumbered collateral. Oops. Something was missed. Some trucks -

MR. POPE: He no longer works with us.

MR. DUEDALL: I'm sorry?

MR. POPE: He no longer works for my firm.

MR. DUEDALL: There shall be a scapegoat as well. We'll talk about that later. A million dollars of unencumbered assets, some patents, some trademarks, some trucks or something like that. Gary, if you have \$1 million of unencumbered assets, and everyone knows. It's opened. It is notorious. Do you tell the bank to jump in a lake? You're going to use their cash collateral because you now have \$1 million that you can give them as new collateral and use their cash collateral to fund their losses. Do you tell them you're done? You're done dealing with them. You're going to hang out in chapter 11 for a year or so. And how different does the conversation become?

MR. MARSH: I think it would be different. We'd first probably get a good CRO so that we could be operating the business on a break-even basis, so it's close enough that my guess is there's something better we could do with operations here. So assuming I could get it on a break-even basis, then I should be able to use Alan's cash collateral and we'd give them a replacement lien and we could decide whether we need to give them a lien on the unencumbered assets. We'd have some time to operate in chapter 11. We may still do a sale, but we've been in cases where on day one everybody's perception of value dramatically changes. Six months into the case something's changed in the industry that makes the company much more valuable and we might be able to actually get a sale or transaction that pays Alan in full and pays unsecureds in

full. We did that in a case last year. So if we have more time then we'd think about a chapter 11 plan, the thing you're in love with, a chapter 11 plan, and we'd get the court to approve it. We'd talk to the bankruptcy judge. But we'd look at what type of plan we could put together, what type of treatment for secured creditors, unsecureds. We'd have to pay the admins in full. We'd have to get an impaired class of creditors to vote yes. I'd go back to the old equity. Maybe they'd be willing to put some money in if it looked like a more viable reorganization effort that we'd have the ability to pull off. I don't think we'd hang out for a year. We've got the cost of bankruptcy, so I think we'd still move fast. We've got the lease deadline of 210 days if we have any leases. So there's pressure on the debtor to move it through the process, and there's an 18-month maximum exclusivity. So I don't think we'd be hanging out but we'd be working hard at trying to figure out if there's a plan we could come up with. We'd go to Alan and see if he'd support it. We'd go to Kay and get her constituency to support it. And if we couldn't, we'd probably get Kay on board. If we couldn't get Alan on board, we'd maybe try to cram him down and get a plan done the old-fashioned way.

MR. DUEDALL: Now, Kay, is this in any way acceptable to you? There's \$1 million of unencumbered assets and only \$5 million in claims. There is a 20¢ distribution that could be had in short order, less professional fees and whatnot. Do you let Gary and his client, this Keystone Cops company, hire more professionals, hire a CRO, talk about cramming down the bank that rarely works. Do you become Gary's enemy in saying we need to have this \$1 million preserved for creditors, not frittered away?

MS. KRESS: I start with the premise that debtors always think time is going to be to their benefit and that time is not always to a debtor's benefit. Sometimes it may work, but not always. And I think it really depends on the relationship with the debtor. Do we trust management? If he's putting in a CRO, he's already telegraphing at least to me and hopefully my constituency that he doesn't have any faith in current management, that he's got to put out more cash that's going to take money out of our pockets to hire somebody who can competently run the debtor, to maybe turn this around to maybe get somewhere. So depending on current management and the confidence that the creditors have in current management and/or the CRO, I don't know that we're going to let them hang out for 18 months. That's a long time if you're suffering losses and you may take all of the equity that we had and all of the distribution that may be in our benefit to convert the case and try to liquidate it.

MR. DUEDALL: Do you team up with Alan and fight off this specious motion to use cash collateral?

MR. POPE: Absolutely.

MS. KRESS: Could be. You have to look at the facts, and it could be to the creditors' advantage to convert the case or to do something immediately so that he can't just dissipate all of that equity.

MR. MARSH: Now might not be the time for me to file my motion to approve my key employee and set-up plan.

MR. POPE: There's a couple of things going on here, and that is the § 363 that is so abhorrent to Mr. Duedall here, we all agree it's fast. So if you can get in and out of bankruptcy in 90 days, you're spending a lot less money. I have not seen a debtor, at least in my experience, although I am sure it has happened, that has increased in value over the course of a case. You've had some that have effectively treaded water, but very rarely do they find the diamond mine or have their business turn around or come up with the next mousetrap that makes it a better company in bankruptcy. So I'm looking at this ice cube in my hand that's constantly melting. I want to get out as quickly as possible. I realize that for whatever reason those unencumbered assets are out there. What are those? In real life it's foreign stock. A lot of you will do—for tax reasons, you usually don't take one-third. You don't take a lien on one-third of their stock for deemed dividend issues. There's always an asset out there somewhere which can be material. And that's when we go to Kay, and I realize, all right, now I need her on my side. This is where the two of us together have to say, fine; that's yours. You and the unsecured creditors go have a party with these unencumbered assets, but walk in front of the court and tell him that yes, an immediate sale to preserve the going concern value which, 12 months later as Gary is still trying to figure out whether he can cram me down, is going to probably be 80% of what it is today. Let's go ahead and get that and sweep that cash today.

MR. DUEDALL: Does our panel have some closing thoughts and comments? And then we'll open it up to questions from this fine audience. Gary?

MR. MARSH: I think the problem really with these cases now is that the money in the case, the lender money or the private equity money, is no longer patient, so they want really fast results. In most of these situations, companies are over-leveraged, and they're fully lien-ed-up so there's no unencumbered assets, and there's claims trading going on, and it's very difficult to confirm a

case now, it's so expensive. We've got the § 366 utility, the § 503(b)(9), the shortened § 365 period, the plan deadlines. It's hard on the debtor and the debtor's counsel. You've got lots of reporting to the U.S. Trustee's Office. You've got U.S. Trustee's fees, and it's just difficult, and that's why I think we're having so many § 363 sales, where when I first started practicing we had more chapter 11 plans. It was more common.

MR. DUEDALL: Kay, do you feel the same?

MS. KRESS: There's just too much debt on these companies, and maybe as the economy turns a little bit then you'll see more reorganizations because there is a lot of money in the market, and you may have investors and you have the pay-to-play lenders now. You do have private equity that goes in and their whole goal is to own this company at some point. The loans can't have very high interest rates or default covenants, and their whole goal is to push this company so that they get to take it over. So I think it really depends on the kind of debt that you have, but there just seems to be a lot of debt on the companies. And I agree. It's been a long time since you saw a company actually use the bankruptcy court to their advantage. Maybe that's because they wait too long to file. You know, you have retail cases, maybe you go in to get rid of a lot of leases. We've seen some reorganizations from that perspective. But if you're just going in because you have too much debt, I think therein lies the problem.

MR. POPE: The very large cases are going to be the ones that you still see going through a chapter 11 process, and there's two things going on. On day one of a case I will typically represent, insert national bank with a syndicate of lenders, that each hold 5% of the credit. As the case progresses, that debt will change and usually it's right before the case even files, and that'll trade out of traditional lender hands and into the hedge funds and CLO's, things like that. People will come in, concentrate the debt, and what they really want to do is own the company. Now all of a sudden a plan process makes sense to them. They're willing to take a note and most of the equity of the company, and let someone else come in and provide a working capital facility. And that's the cases that I see that will continue to use a traditional chapter 11 process.

MS. KRESS: Or if you need releases somehow. Sometimes lenders will fund a plan because they can get releases through a plan that they cannot get in any other part of a case.

MR. POPE: Absolutely.

MR. DUEDALL: I think that's true. There is some hope for chapter 11, but it is a unique case for it. It requires a different kind of lender, a different kind of business and whatnot.

MR. POPE: The smaller single bank deals, it's just not attractive anymore. And that's why you're willing to do a sale where you go ahead and take care of all the unsecured creditors or something like that, unless there's something else driving you into bankruptcy. Kay gave a great example: Retails, restaurants, movie theaters, anyone who's trying to use the lease provisions. Oftentimes you have to go into bankruptcy for other reasons.

MR. DUEDALL: And I think Gary's right and we appropriately put him in the middle. The job of debtor's counsel is the hardest and the most challenging. The rocks are thrown at you from all directions.

MS. KRESS: I have a question for Gary. Would you ever go into a chapter 11 without an exit strategy?

MR. MARSH: Not ideally, but that happens.

MS. KRESS: You should know how you're going to get out of chapter 11 before you—those are the most successful chapter 11's, if you know how you're going to get out before you get in.

MR. DUEDALL: Chapter 11, like a roach motel, you can check in, never check out. Let's have some questions from our audience, the students or the practitioners or the members of the bench, please. A lot of folks have different experiences on this or would like some more insight. Do we have questions? Goodness. We've solved modern chapter 11 practice.

MR. POPE: It was that compelling.

MR. DUEDALL: Folks, with that, thank you so much. I really appreciate our panelists. They came a long way for this and did a lot of work putting this together. Alex.

MR. CLAMON: Ladies and gentlemen, this concludes this year's symposium Thank you, everyone, and we hope everyone has a safe trip home.